United States Court of Appeals

for the Second Circuit

APPELLEE'S BRIEF

75-4138

IN THE UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

GERALD F. PADUANO and CAROLINE PADUANO,

Appellants

v.

COMMISSIONER OF INTERNAL REVENUE,

Appellee

ROCCO M. CAPPUCILLI and DOROTHY CAPPUCILLI,

Appellants

v.

COMMISSIONER OF INTERNAL REVENUE,

Appellee

PETER L. CAPPUCILLI and GRACE A. CAPPUCILLI,

Appellants

v.

COMMISSIONER OF INTERNAL REVENUE,

Appellee

ON APPEALS FROM THE DECISIONS OF THE
UNITED STATES TAX COURT

BRIEF FOR THE APPELLEE

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STATEMENT OF THE ISSUE PRESENTED

Whether the Tax Court properly sustained the Commissioner's allocation of interest income (and correlative interest deductions) under Section 482 of the Internal Revenue Code of 1954 where

such an allocation was based on the failure to charge an arm's length interest rate on loans from a partnership to corporations owned by the partners.

STATEMENT OF THE CASE

These appeals involve deficiencies in income taxes totalling $83,429.44 for the years 1967, 1968, and 1969. (R. 72-74.)[1/] The memorandum findings of fact and opinion of the Tax Court (Judge Fay) (R. 75-84) are reported at P-H Memo T.C., par. 75,069. The decisions of the Tax Court were entered April 1, 1975. (R. 72-74.) Notices of appeal were filed on July 1, 1975 (R. 2, 4, 6) (but were postmarked in June, and were thus timely). This Court has jurisdiction under Section 7482 of the Internal Revenue Code of 1954 (26 U.S.C.).

Taxpayers Gerald Paduano, Rocco Cappucilli, and Peter Cappuccilli[2/] during the relevant years were equal partners in a partnership (Cappuccilli, Cappuccilli, and Paduano, hereafter CCP) which was engaged in the business of re ting and selling real property. Each of the taxpayers also held a one-third stock interest in Stonehedge Development Corporation (Stonehedge), Seneca Sewage Corporation (Seneca) and Cappy's Real Estate, Inc. (Cappy's). (R. 76-77.) CCP sold land to Seneca and Stonehedge, and during the years in issue CCP held purchase money mortgage notes from Stonehedge in the amount of $1,122,850 and a purchase money mortgage note from Seneca in

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1/ "R." references are to the separately bound record appendix. "Ex. Vol." references are to the pages of the separately bound exhibit volume.

the amount of $25,000, and made numerous unsecured short-term loans, or advances, to Cappy's and Stonehedge. (R. 64-69.) No interest was paid on any of these loans during the tax years at issue. (R. 65, 79.) The only loans from CCP which even provided for the payment of interest, though it was not paid, were a $25,000 mortgage loan to Seneca from CCP and a $81,000 mortgage loan from CCP to Stonehedge. (R. 65, 78.) Stonehedge and Seneca paid interest to other creditors during the years at issue. (R. 79.)

Pursuant to his statutory authority under Section 482 of the Internal Revenue Code, the Commissioner allocated interest income at the rate of 5 percent per annum to CCP on these loans. (R. 81.) Correlative interest deductions were allowed Stonehedge, Seneca and Cappy's. (R. 81.) The interest allocation increased the income of the partnership, CCP, and thus each partner's distributive share of partnership income and each partner's individual income tax. (R. 14-20, 30-35, 46-53.) The partners and their spouses petitioned the Tax Court for redetermination of the asserted deficiencies; the Tax Court sustained the Commissioner's Section 482 allocation. From the Tax Court's decisions against them, taxpayers now bring these appeals.

2/ Caroline Paduano, Dorothy Cappucilli and Grace Cappuccilli are parties to this action only by virtue of having filed joint income tax returns with their husbands.

SUMMARY OF ARGUMENT

This case involves a partnership, CCP, which made interest-free loans to corporations owned entirely by the partners. Under the authority of Section 482, the Commissioner allocated income and deductions so as to reflect an arm's-length interest charge on these loans. Each partner was then taxed on his distributive share of the partnership's increased income.

No challenge is made that CCP and the three corporations (Seneca, Stonehedge, and Cappy's) do not constitute two or more trades or businesses, or that they are not controlled by the same interests. Rather, taxpayers challenge the propriety of the allocation on three grounds, none of which has legal or factual support.

Taxpayers first claim that the Commissioner simply has no power to make a Section 482 alloation with respect to a purchase money mortgage[3/] for an asset which is a capital asset to the seller. They cite no case, ruling, or regulation which so holds. Instead, they reason that such loans must be excluded since they are not specifically included in Treasury Regulations Section 1.482-2(a)(3), defining "loans or advances." That regulation, however, provides that the defined terms include "all forms of bona fide indebtedness," and is broad enough to reach purchase money mortgages for capital assets. The construction for which taxpayers contend would fail to

3/ We shall occasionally refer to the indebtedness secured by the purchase money mortgages as purchase money mortgages.

carry out the purpose of Section 482, and would--if accepted--create an entirely unjustified loophole in the law. Finally, even if the point otherwise had any merit, taxpayers have not proved that the farms involved were in fact capital assets in the hands of CCP.

Taxpayers next claim that the purchase price of certain parcels of land included unstated interest, and that, as to those loans, allocation is unnecessary. The Tax Court rejected their claim of unstated interest and that rejection is not clearly erroneous. The only evidence of unstated interest was the self-serving, uncorroborated testimony of one taxpayer. That individual had made prior inconsistent representations, and made no effort to explain certain inconsistencies in his testimony. The Tax Court, as trier of fact, and with an opportunity to view the demeanor of the witness, was not in error in rejecting the testimony.

Lastly, taxpayers claim that the allocation was improper because Seneca, Stonehedge and Cappy's were unable to pay interest because of their precarious financial position. They cite no direct support for this contention, but reason by analogy from a line of cases dealing with the accrual of interest income. That particular analogy has been rejected, and properly so, by this Court, the Court of Appeals for the Eighth Circuit, and the Tax Court. It should again be rejected here. In fact, Stonehedge, Seneca, and Cappy's paid interest

to other creditors. By making interest-free loans to related parties, CCP divested itself of interest income it would otherwise have earned in a competitive market. Allocation of income under Section 482 has been held to be proper in such cases. The decision below is correct and should be affirmed.

ARGUMENT

THE TAX COURT PROPERLY SUSTAINED THE COMMISSIONER'S ALLOCATION OF INCOME AND DEDUCTIONS MADE TO REFLECT THE CHARGE OF AN ARM'S-LENGTH INTEREST RATE ON LOANS FROM THE PARTNERSHIP TO COMPANIES OWNED BY THE PARTNERS

A. Introduction

Section 482, Internal Revenue Code of 1954, Appendix, infra, and the Treasury Regulations thereunder authorize the allocation of gross income and a member of a group of commonly controlled organizations which makes interest-free loans to other members of the group, so as to reflect an arm's-length interest charge. Treasury Regulations on Income Tax (1954 Code), §1.482-2(a), Appendix, infra. Allocations under this Treasury regulation have been repeatedly upheld in this and other Circuits. B. Forman Co. v. Commissioner, 453 F. 2d 1144, 1156 (C.A. 2, 1972), cert. denied, 407 U.S. 934 (1972), rehearing denied, 409 U.S. 899 (1972); Kahler Corp. v. Commissioner, 486 F. 2d 1, 4-5 (C.A. 8, 1973); Kerry Investment Co. v. Commissioner, 500 F. 2d 108, 109 (C.A. 9, 1974); Fitzgerald Motor Co. v. Commissioner, 508 F. 2d 1096, 1100-1101 (C.A. 5, 1975).

In order to make an allocation of income pursuant to Section 482, "the Commissioner must find that (1) there are two or more trades, businesses or organizations (2) owned or controlled by the same interests and (3) that it is necessary to allocate gross income, deductions, credits, or allowances among them in order to prevent evasion of taxes or in order to clearly reflect their income." B. Forman Co., supra, p. 1152. Stonehedge, Seneca, Cappy's and CCP clearly constitute two or more organizations, trades or businesses.[4/] It is undisputed that they are owned and controlled by the same interests, the three taxpayers.[5/] The Commissioner allocated interest income to CCP in an amount which reflected an arm's-length interest charge to Stonehedge, Seneca, and Cappy's for the use of the money loaned by CCP. This allocation is specifically authorized by Treasury Regulations Section 1.482-2(a), which provides that when one member of a group of controlled entities becomes a creditor of another member of the group and charges no interest, "the district director may make appropriate allocations to reflect an arm's length interest rate for the use of such loans or advance." This Court has found the quoted regulation to be

4/ An organization, trade or business for purposes of Section 482 may be an individual conducting a business, or a partnership, as well as a corporation. Borge v. Commissioner, 405 F. 2d 673, 675 (C.A. 2, 1973), cert. denied sub nom. Danica Enterprise, Inc. v. Commissioner, 395 U.S. 933 (1969); Grenada Industries, Inc. v. Commissioner, 202 F. 2d 873 (C.A. 5, 1953), cert. denied, 346 U.S. 819 (1953).

5/ Control under Section 482 may be exercised by owners of less than a majority interest who act in concert. B. Forman Co., supra, pp. 1152-1155.

"entirely consistent with the scope and purpose of §482" (B. Forman Co., supra, p. 1156), and therefore, the regulation must be sustained (Commissioner v. South Texas Co., 333 U.S. 496, 501 (1948)). Insofar as the allocation does reflect an arm's-length interest charge it reflects the true taxable income of all the entities involved. Treasury Regulations §1.482-1(a)(6), Appendix, infra; B. Forman Co., supra, p. 1156. That is the purpose of Section 482, Commissioner v. First Security Bank of Utah, 405 U.S. 394, 400 (1972).

The Commissioner's allocation of income under Section 482 may be set aside by the courts only if "unreasonable, arbitrary, or capricious." Your Host, Inc. v. Commissioner, 489 F. 2d 957, 960 (C.A. 2, 1973), cert. denied, 419 U.S. 829 (1974). The Tax Court's decision sustaining the deficiencies determined by the Tax Court should be affirmed unless found to be clearly erroneous. B. Forman Co., supra, p. 1152, and cases cited therein. The Commissioner submits, as set forth below, that taxpayers' arguments before this Court do not establish it as clearly erroneous.

B. Section 482 applies to the purchase money mortgages in this case

Taxpayers claim (Br. 17) that, "Section 482 does not apply to the sale of a capital asset * * *." They go on to argue that the farms sold by CCP to Seneca and Stonehedge were

capital assets in the hands of CCP and that, under taxpayers' restricted view of the application of Section 482, the Commissioner had no power to allocate interest income to CCP based on the purchase money mortgages created to finance the sale of the farms. Taxpayers' contention is totally without foundation. There is no basis in the statute or the Regulations to conclude that Section 482 does not apply to debts generated by the sale of capital assets. Taxpayers cite no case, regulation or ruling which so holds. They recognize (Br. 17) that Treasury Regulations Section 1.482-2(a)(3) provides, quite to the contrary, that the term "loans or advances" includes "all forms of bona fide indebtedness" (emphasis added) and includes "Loans or advances of money or other consideration * * *." Certainly the Regulations fairly comprehend debts secured by purchase money mortgages, yet taxpayers construe a statement (Br. 17) in Treasury Regulations Section 1.482-2(a)(3)(ii), that Section 482 reaches indebtedness arising out of the ordinary course of business, as meaning that Section 482 reaches only indebtedness arising out of sales made in the ordinary course of business the premise apparently being that sales of capital assets, as opposed to sales of dealer property, are outside the scope of Section 482 as not in the ordinary course of business.[6/] This argument is wholly

6/ Taxpayers then devote most of their argument to the proposition that the real estate sold by the partnership was in fact a capital asset in its hands.

without merit; the clear import of the regulation is to reach all forms of debt, whether its genesis is the sale of inventory or capital assets. We know of no authority for the proposition that Section 482 may not be utilized in the context of a loan related to the sale of a capital asset. The Treasury Regulations quoted above certainly indicate that the purchase money mortgage loans CCP made to Stonehedge and Seneca are within the ambit of Section 482.

Indeed, to exclude the loans secured by purchase money mortgages here involved from the application of Section 482 would be contrary to the purpose of Section 482, which is to prevent the shifting of profits or deductions among members of a commonly controlled group of organizations. B. Forman Co., supra, p. 1151; accord, Commissioner v. First Security Bank of Utah, 405 U.S. 394, 400 (1972). There is no essential difference between the debt transactions here in issue and those types of indebtedness to which taxpayers concede that Section 482 does apply which would justify a difference in treatment so as to create a loophole in the law and frustrate the intent of Congress. There has simply been no reason or authority advanced by taxpayers to support their attempt to avoid Treasury Regulations Section 1.482-2(a)(3), which provides, in essence, that arm's-length interest income may be allocated with respect to "all forms of bona fide indebtedness."

The regulation should be sustained unless it is unreasonable and plainly inconsistent with the statute. B. Forman Co., supra, p. 1152, and cases cited therein. No showing of inconsistency or unreasonableness has been attempted, let alone made.

But even if this Court were to accept the taxpayers' theory that Section 482 is inapplicable to debts secured by purchase money mortgages where one member of a controlled group sells a capital asset to another member, taxpayers have not met their factual burden in this case. The Commissioner's determination to allocate income under Section 482 must be sustained if supported by substantial evidence. B. Forman Co., supra, p. 1152. It was stipulated below (R. 62) that CCP was "principally engaged in the business of renting and selling real estate." CCP was, in effect, a real estate dealer. The record does not indicate that the land involved was set aside as investment property or otherwise segregated from ordinary stock in trade. Contemporaneously with the sales of the subject real estate, CCP reported the income as being income from the sale of assets not qualifying for capital gains treatment. (Ex. Vol. 11.) In view of CCP's dealer status and contemporaneous statement that the real estate sales were not sales of capital assets, there is substantial evidence to support the determination that the sales of the farms at issue were not sales of capital assets.

C. Taxpayers did not establish that unstated interest was included in the price at which CCP sold real estate to Stonehedge and Seneca

Taxpayers claim that Section 482 is not applicable to the sales of the farm by CCP to Seneca and Stonehedge because unstated interest was included in the selling price of the farms. The Tax Court considered this claim and rejected it. (R. 84.) That rejection should be affirmed unless clearly erroneous.

Taxpayers claim in their brief (Br. 28, 29, 30) that taxpayer Peter Cappuccilli testified at trial that in the sales of Preston Farm, the Henderson Farm, and the Seneca Knolls property, the sale price was higher than the fair market value, and that this difference was intended to be unstated interest in the 7 to 8 percent range on CCP's equity in the properties. Taxpayers claim that the Tax Court was bound to accept Peter Cappuccilli's testimony. (Br.31-32.) This is not the case. The issue of credibility is for the Tax Court to resolve, and it is not required to accept an interested party's testimony as to purpose and intent. PEPI, Inc. v. Commissioner, 448 F. 2d 141, 147 (C.A. 2, 1971). The Tax Court is not bound to believe even uncontradicted testimony where that testimony appears improbable. MacGuire v. Commissioner, 450 F. 2d 1239, 1244 (C.A. 5, 1971), and cases cited therein. Clearly the Tax Court believed Peter Cappuccilli's

testimony to be improbable. This belief was well justified. The mortgage notes in the Preston Farm and Henderson Farm sales expressly provided for interest at the rate of 6 percent (R. 78), which interest was not paid (R. 65). No explanation was offered as to why taxpayers would provide expressly for interest in these two sales and then, according to the testimony of Peter Cappuccilli, also provide for unstated interest and then not require payment of the expressly stated interest. No provision was made in the sales agreement for a rebate of the unstated interest in the event of prepayment of the notes. (R. 83.) No explanation was offered as to why the purported unstated interest rates on the three sales in 1961 and 1962 ranged from 7.5 to 12 percent. (R. 83.) (They appear to be numbers chosen after the fact, based upon the consideration that their use yielded the desired result). Further, and perhaps most damaging, taxpayer Peter Cappuccilli had subscribed, under penalty of perjury, to declarations there there was no agreement, oral or otherwise, providing for the payment of interest on the obligations of Stonehedge and Seneca to CCP. (Ex. Vol. 40, 42, 45, 47.) Peter Cappuccilli stated that he had discussed the sales here involved with his lawyers and accountants, who were still alive (R. 128-129); yet no witnesses were produced to corroborate his testimony with respect to unstated interest. Not even the testimony of his fellow taxpayers was offered in corroboration.

The Tax Court's decision not to accept Peter Cappuccilli's uncorroborated, self-serving testimony cannot be said to be clearly erronoeus, and must therefore be sustained. Commissioner v. Duberstein, 363 U.S. 278, 291 (1960).

D. Section 482 was properly applied to allocate income to CCP, to reflect arm's-length interest rates on the loans involved, without reference to the profit position of the obligor corporations

Taxpayers claim that the allocation of income to CCP here involved is improper because, they claim, the evidence shows that Stonehedge, Seneca, and Cappy's were unable to pay interest in the years involved. Taxpayers point out (Br. 37) that the obligor corporations in the years at issue reported very small, or no, taxable income, small cash balances, and large current liabilities. To support this proposition, taxpayers cite several cases (Br. 39) which hold that an accrual basis taxpayer is not required to accrue interest where the obligor is in such difficult financial straits that it could not be expected to pay the interest. They analogize those cases to Section 482, and contend that allocation is improper in this case because of the difficult financial situations of Stonehedge, Seneca, and Cappy's. This Court, however, has rejected the same argument in B. Forman Co., supra, p. 1156, when it ruled that while the holding of Atchison, Topeka & Santa Fe Railway Co. v. Commissioner, 36 T.C. 584 (1961) (a case

where a creditor was not required to accrue interest due from an insolvent debtor), might be correct "from a pure accounting standpoint," this rule was not in harmony with economic reality or with the declared purpose of Section 482, and did not control the allocation of interest income under Section 482. The Court of Appeals for the Eighth Circuit has adopted that portion of this Court's opinion. Kahler Corp., supra. Judge Featherston's dissenting opinion in Kerry Investment Co. v. Commissioner, 58 T.C. 479, 494-496 (1972), which was approved by the Court of Appeals in affirming in part and reversing in part, also rejected the notion that the accrual accounting conception was valid for purposes of Section 482.

Taxpayer correctly points out that in Pitchford's Inc. v. Commissioner, 34 T.C.M. 384 (1975), counsel for the Commissioner made a concession that if accrual would not have been required due to the shaky financial situation of the debtor, allocation of interest under Section 482 would also be improper. The Tax Court stated (34 T.C.M., p. 386), "We express no views on the question whether allocation of interest income under section 482 is indeed precluded where there would not have been a reasonable expectancy of collection of such interest. For purposes of this case only, we accept respondent's concession on this point." In view of the position taken by this Court in B. Forman, supra, p. 1156, the Court of Appeals for the Eighth Circuit in

Kahler Corp., supra, and the Tax Court in Kerry Investment Co., supra, pp. 491-492, the concession in Pitchford's Inc., supra, may perhaps be viewed as improvident, and in any event should be given no effect beyond the case in which the concession was made. Taxpayer's citation of Commissioner v. First Security Bank of Utah, supra, and L.E. Strunk Latex Products, Inc. v. Commissioner, 18 T.C. 940 (1952), is inapposite. Those cases dealt with the attribution of income which the taxpayer was legally prohibited from receiving. No such prohibition is involved in this case.

Taxpayers' claims are further erroneous insofar as they are based on a showing of lack of taxable income and cash on hand at years end. (Br. 37.) Such factors are irrelevant. Section 482, Appendix, infra, deals with the allocation of "gross income," deductions, credits, or allowances." It is not dependent upon profits, taxable income, or cash on hand Midtown Holdings Corporation, the obligor in B. Forman Co., supra, was a loss corporation (B. Forman Co., supra, p. 1154) presumably without taxable income, yet this Court approved the allocation of income from Midtown to the taxpayers in that case.

Treasury Regulations Section 1.482-1(c), Appendix, infra, provides that the authority to make a Section 482 allocation "extends to any case in which * * * the taxable income * * * of a controlled taxpayer, is other than it would have been had the taxpayer in the conduct of his affairs

been an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer." The Court of Appeals for the Eighth Circuit is in agreement, stating (Kahler Corp. v. Commissioner, supra, p. 5):

> The proper standard to be applied in cases such as this is whether or not the loans from the taxpayer to other members of the controlled group would have been made on an interest free basis in arm's length dealings between uncontrolled taxpayers.

Taxpayers have not attempted any showing that an uncontrolled entity dealing at arm's length would have made the interest-free loans CCP made. When CCP made interest-free loans exceeding one million dollars it was divesting itself of interest income that it could have earned by making loans in the competitive market. In such a case a Section 482 allocation is proper. Kerry Investment Co., supra, 500 F. 2d, p. 109.

CONCLUSION

For the reasons appearing above the decisions of the Tax Court should be affirmed.

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OCTOBER, 1975.

CERTIFICATE OF SERVICE

It is hereby certified that service of this brief has been made on opposing counsel by mailing four copies thereof on this 8th day of October, 1975, in an envelope, with postage prepaid properly addressed to him as follows:

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APPENDIX

Internal Revenue Code of 1954 (26 U.S.C.):

SEC. 482. ALLOCATION OF INCOME AND DEDUCTIONS AMONG TAXPAYERS.

In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary or his delegate may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses.

Treasury Regulations on Income Tax (1954 Code) (26 C.F.R.):

§1.482-1 Allocation of income and deductions among taxpayers.

(a) Definitions. When used in this section and in §1.482-2--

* * *

(6) The term "true taxable income" means, in the case of a controlled taxpayer, the taxable income (or, as the case may be, any item or element affecting taxable income) which would have resulted to the controlled taxpayer, had it in the conduct of its affairs (or, as the case may be, in the particular contract, transaction, arrangement, or other act) dealt with the other member or members of the group at arm's length. It does not mean the income, the deductions, the credits, the allowances, or the item or element of income, deductions, credits, or allowances, resulting to the controlled taxpayer by reason of the particular contract, transaction, or arrangement, the controlled taxpayer, or the interests controlling it, chose to make (even though such contract, transaction, or arrangement be legally binding upon the parties thereto).

* * *

(c) Application. Transactions between one controlled taxpayer and another will be subjected to special scrutiny to ascertain whether the common control is being used to reduce, avoid, or escape taxes. In determining the true taxable income of a controlled taxpayer, the district director is not restricted to the case of improper accounting, to the case of a fraudulent, colorable, or sham transaction, or to the case of a device designed to reduce or avoid tax by shifting or distorting income, deductions, credits, or allowances. The authority to determine true taxable income extends to any case in which either by inadvertence or design the taxable income, in whole or in part, of a controlled taxpayer is other than it would have been had the taxpayer in the conduct of his affairs been an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer.

* * *

§1.482-2 Determination of taxable income in specific situations.

(a) Loans or advances--(1) In general. Where one member of a group of controlled entities makes a loan or advance directly or indirectly to, or otherwise becomes a creditor of, another member of such group, and charges no interest, or charges interest at a rate which is not equal to an arm's length rate as defined in subparagraph (2) of this paragraph, the district director may make appropriate allocations to reflect an arm's length interest rate for the use of such loan or advance.

* * *

(3) Loans or advances to which subparagraph (1) applies. Subparagraph (1) of this paragraph applies to all forms of bona fide indebtedness and includes:

(i) Loans or advances of money or other consideration (whether or not evidenced by a written instrument), and

(ii) Indebtedness arising in the ordinary course of business out of sales, leases, or the rendition of services by or between members of the group, or any other similar extension of credit.

* * *